

business practice of this particular taxpayer to breed the offspring of his herd which he is holding for sale to others prior to sale in order to establish their fitness for sale as registered breeding cattle. In such case, the taxpayer's breeding of such offspring is an ordinary and necessary incident to his holding them for the purpose of selling them as bred heifers or proven bulls and does not demonstrate that the taxpayer is holding them for breeding purposes. However, those cattle held by the taxpayer as additions or replacements to his own breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves.

*Example 6.* A taxpayer, engaged in the business of buying cattle and fattening them for slaughter, purchased cows with calf. The calves were born while the cows were held by the taxpayer. These cows are not considered as held for breeding purposes.

(c)(1) For purposes of paragraph (b) of this section, a horse held for racing purposes shall be considered as held for sporting purposes. Whether a horse is held for racing purposes shall be determined in accordance with the following rules:

(i) A horse which has actually been raced at a public race track shall, except in rare and unusual circumstances, be considered as held for racing purposes.

(ii) A horse which has not been raced at a public track shall be considered as held for racing purposes if it has been trained to race and other facts and circumstances in the particular case also indicate that the horse was held for this purpose. For example, assume that the taxpayer maintains a written training record on all horses he keeps in training status, which shows that a particular horse does not meet objective standards (including, but not limited to, such considerations as failure to achieve predetermined standards of performance during training, or the existence of a physical or other defect) established by the taxpayer for determining the fitness and quality of horses to be retained in his racing stable. Under such circumstances, if the taxpayer disposes of the horse within a reasonable time after he determined that it did not meet his objective standards for retention, the horse shall be considered as held for racing purposes.

(iii) A horse which has neither been raced at a public track nor trained for racing shall not, except in rare and unusual circumstances, be considered as held for racing purposes.

(2) This paragraph may be illustrated by the following examples:

*Example 1.* The taxpayer breeds, raises, and trains horses for the purpose of racing. Every year he culls some horses from his racing stable. In 1971, the taxpayer decided that in order to prevent his racing stable from getting too large to be effectively operated he must cull six horses from it. All six of the horses culled by the taxpayer had been raced at public tracks in 1970. Under subparagraph (1)(i) of this paragraph, all these horses are considered as held for racing purposes.

*Example 2.* Assume the same facts as in example (1). Assume further that the taxpayer decided to cull four more horses from his racing stable in 1971. All these horses had been trained to race but had not been raced at public tracks. The taxpayer culled these four horses because the training log which the taxpayer maintains on all the horses he trains showed these horses to be unfit to remain in his racing stable. Horse A was culled because it developed shin splints during training. Horses B and C were culled because of poor temperament. B bolted every time a rider tried to mount it, and C became extremely nervous when it was placed in the starting gate. Horse D was culled because it did not qualify for retention under one of the objective standards the taxpayer had established for determining which horses to retain since it was unable to run a specified distance in a minimum time. These four horses were disposed of within a reasonable time after the taxpayer determined that they were unfit to remain in his stable. Under subparagraph (1)(ii) of this paragraph, all these horses are considered as held for racing purposes.

[T.D. 7141, 36 FR 18792, Sept. 22, 1971]

#### § 1.1232-1 Bonds and other evidences of indebtedness; scope of section.

(a) *In general.* Section 1232 applies to any bond, debenture, note, or certificate or other evidence of indebtedness (referred to in this section and §§ 1.1232-2 through 1.1232-4 as an obligation) (1) which is a capital asset in the hands of the taxpayer, and (2) which is issued by any corporation, or by any government or political subdivision thereof. In general, section 1232(a)(1) provides that the retirement of an obligation, other than

certain obligations issued before January 1, 1955, is considered to be an exchange and, therefore, is usually subject to capital gain or loss treatment. In general, section 1232(a)(2)(B) provides that in the case of a gain realized on the sale or exchange of certain obligations issued at a discount after December 31, 1954, which are either corporate bonds issued on or before May 27, 1969, or government bonds, the amount of gain equal to such discount or, under certain circumstances, the amount of gain equal to a specified portion of such discount, constitutes ordinary income. In the case of certain corporate obligations issued after May 27, 1969, in general, section 1232(a)(3) provides for the inclusion as interest in gross income of a ratable portion of original issue discount for each taxable year over the life of the obligation, section 1232(a)(3)(E) provides for an increase in basis equal to the original issue discount included in gross income, and section 1232(a)(2)(A) provides that any gain realized on such an obligation held more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall be considered gain from the sale or exchange of a capital asset held more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). For the requirements for reporting original issue discount on certain obligations issued after May 27, 1969, see section 6049(a) and the regulations thereunder. Section 1232(c) treats as ordinary income a portion of any gain realized upon the disposition of (i) coupon obligations which were acquired after August 16, 1954, and before January 1, 1958, without all coupons maturing more than 12 months after purchase attached, and (ii) coupon obligations which were acquired after December 31, 1957, without all coupons maturing after the date of purchase attached.

(b) *Requirement that obligations be capital assets.* In order for section 1232 to be applicable, an obligation must be a capital asset in the hands of the taxpayer. See section 1221 and the regulations thereunder. Obligations held by a dealer in securities (except as provided in section 1236) or obligations arising from the sale of inventory or personal

services by the holder are not capital assets. However, obligations held by a financial institution, as defined in section 582(c) (relating to treatment of losses and gains on bonds of certain financial institutions) for investment and not primarily for sale to customers in the ordinary course of the financial institution's trade or business, are capital assets. Thus, with respect to obligations held as capital assets by such a financial institution which are corporate obligations to which section 1232(a)(3) applies, there is ratable inclusion of original issue discount as interest in gross income under paragraph (a) of § 1.1232-3A, and gain on a sale or exchange (including retirement) may be subject to ordinary income treatment under section 582(c) and paragraph (a)(1) of § 1.1232-3.

(c) *Face-amount certificates*—(1) *In general.* For purposes of section 1232, this section and §§ 1.1232-2 through 1.1232-4, the term *other evidence of indebtedness* includes *face amount certificates* as defined in section 2(a)(15) and 4 of the Investment Company Act of 1940 (15 U.S.C. 80a-2 and 80a-4).

(2) *Amounts received in taxable years beginning prior to January 1, 1964.* Amounts received in taxable years beginning prior to January 1, 1964 under face amount certificates which were issued after December 31, 1954, are subject to the limitation on tax under section 72(e)(3). See paragraph (g) of § 1.72-11 (relating to limit on tax attributable to receipt of a lump sum received as an annuity payment). However, section 72(e)(3) does not apply to any such amounts received in taxable years beginning after December 31, 1963.

(3) *Certificates issued after December 31, 1975.* In the case of a face-amount certificate issued after December 31, 1975 (other than such a certificate issued pursuant to a written commitment which was binding on such date and at all times thereafter), the provisions of section 1232(a)(3) (relating to the ratable inclusion of original issue discount in gross income) shall apply. See section 1232-3A(f). For treatment of any increase in basis under section 1232(a)(3)(A) as consideration paid for purposes of computing the investment in the contract under section 72, see § 1.72-6(c)(4).

(d) *Certain deposits in financial institutions.* For purposes of section 1232, this section and §§ 1.1232-2 through 1.1232-4, the term *other evidence of indebtedness* includes certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions. For application of section 1232 to such deposits, see paragraph (e) of § 1.1232-3A. However, section 1232, this section, and §§ 1.1232-2 through 1.1232-4 shall not apply to such deposits made prior to January 1, 1971. For treatment of renewable certificates of deposit, see paragraph (e)(4) of § 1.1232-3A.

[T.D. 7154, 36 FR 25000, Dec. 28, 1971, as amended by T.D. 7311, 39 FR 11880, Apr. 1, 1974; T.D. 7365, 40 FR 27936, July 2, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

#### § 1.1232-2 Retirement.

Section 1232(a)(1) provides that any amount received by the holder upon the retirement of an obligation shall be considered as an amount received in exchange therefor. However, section 1232(a)(1) does not apply in the case of an obligation issued before January 1, 1955, which was not issued with interest coupons or in registered form on March 1, 1954. For treatment of gain on an obligation held by certain financial institutions, see section 582(c) and paragraph (a)(1)(iii) of § 1.1232-3.

[T.D. 7154, 36 FR 25000, Dec. 28, 1971]

#### § 1.1232-3 Gain upon sale or exchange of obligations issued at a discount after December 31, 1954.

(a) *General rule; sale or exchange—(1) Obligations issued by a corporation after May 27, 1969—(i) General rule.* Under section 1232(a)(2)(A), in the case of gain realized upon the sale or exchange of an obligation issued at a discount by a corporation after May 27, 1969 (other than an obligation subject to the transitional rule of subparagraph (4) of this paragraph), and held by the taxpayer for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977):

(a) If at the time of original issue there was no intention to call the obligation before maturity, such gain shall

be considered as long-term capital gain, or

(b) If at the time of original issue there was an intention to call the obligation before maturity, such gain shall be considered ordinary income to the extent it does not exceed the excess of:

(1) An amount equal to the entire *original issue discount*, over

(2) An amount equal to the entire *original issue discount* multiplied by a fraction the numerator of which is the sum of the number of complete months and any fractional part of a month elapsed since the date of original issue and the denominator of which is the number of complete months and any fractional part of a month from the date of original issue to the stated maturity date.

The balance, if any, of the gain shall be considered as long-term capital gain. The amount described in (2) of this subdivision (b) in effect reduces the amount of original issue discount to be treated as ordinary income under this subdivision (b) by the amounts previously includible (regardless of whether included) by all holders (computed, however, as to any holder without regard to any purchase allowance under paragraph (a)(2)(ii) of § 1.1232-3A and without regard to whether any holder purchased at a premium as defined in paragraph (d)(2) of § 1.1232-3).

(ii) *Cross references.* For definition of the terms *original issue discount* and *intention to call before maturity*, see paragraphs (b) (1) and (4) respectively of this section. For definition of the term *date of original issue*, see paragraph (b)(3) of this section. For computation of the number of complete months and any fractional portion of a month, see paragraph (a)(3) of § 1.1232-3A.

(iii) *Effect of section 582(c).* Gain shall not be considered to be long-term capital gain under subdivision (i) of this subparagraph if section 582(c) (relating to treatment of losses and gains on bonds of certain financial institutions) applies.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example 1.* On January 1, 1970, A, a calendar-year taxpayer, purchases at original issue for cash of \$7,600, M Corporation's 10-